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SIPDIS

SENSITIVE

STATE FOR E, EUR/SE, AND EB/IFD
TREASURY FOR OASIA - RAKINS AND MMILLS
NSC FOR BRYZA AND MCKIBBEN
BUDAPEST FOR WILLIAM SUDMANN

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SUBJECT: MEETINGS WITH BANK REGULATORY BODY CHAIRMAN, IMF
AND CENTRAL BANK VICE-GOVERNOR

REF: ANKARA 2490

11. (Sbu) Summary: Bank regulatory board Chairman Bilgin and IMF Deputy ResRep Klingen expressed concerns about a recent court ruling over the failure of Demir and Kent Banks, which could open the door to failed banks owners getting new banking licenses. Bilgin and Central Bank Vice-Governor Basci claimed regulators were watching bank positions closely. Basci confirmed Klingen's suspicion that the GOT was allowing excise taxes to be squeezed rather than allowing pump prices for gasoline to rise despite higher world oil prices and a weaker lira. Bilgin revealed that he was very unhappy with the Prime Ministry's proposed legislation on independent regulatory boards, which would significantly reduce the bank regulatory body's independence. Klingen said that Anne Krueger had discussed the future IMF role, but the GOT has not yet decided what to ask for. End Summary.

Demir and Kent Bank Court Ruling:

12. (Sbu) In separate meetings with econoffs May 7 and 10, Bank Regulatory and Supervisory Agency (BRSA) Chairman Tevfik Bilgin and IMF Deputy ResRep Christoph Klingen expressed concern about the ramifications of the State Adminstrative Court's (Danistay) ruling against the BRSA's intervention in Demir and Kent during the 2001 financial crisis (reftel). Bilgin and Klingen agreed that the Danistay ruling did not mean the former owners would get their banks back, but worried about the implications for the BRSA's future credibility and about how things might play out if the former owners applied for either banking licenses or compensation.

13. (Sbu) Bilgin wondered whether the former owners might use the court ruling to try to obtain compensation if BRSA refuses to grant them new banking licenses. He said he planned to use the compensation issue against the owners by demanding the owners repay the BRSA for the cost of its intervention with interest. On the licence issue, Bilgin acknowledged that he was worried about his board's ability to deny a licence to the former owners, because they could sue the board citing the Danistay ruling as a basis to argue that they were not responsible for the bank failures.

14. (Sbu) Klingen said the IMF is very unhappy about the Danistay reaffirming its decision despite high-level pressure from the Fund on the GOT. He noted that the Danistay seems to second-guess the BRSA's technical decisions as a regulator rather than restricting itself to judging whether the BRSA acted within its authority. Klingen said Fund staff suspects corruption through the Danistay's use of outside "experts" who were probably paid off by the former owners. The IMF has not yet decided what to do about the situation, though it will be watching closely whether the BRSA gives the former owners new licences. Klingen said corrective actions on this issue could shape

up as the most contentious issue in the upcoming Eighth Review negotiations. More broadly, however, he said the IMF is pleased with Bilgin, who has turned out to be better than expected.

Cukurova Group:

15. (Sbu) Econoffs asked Bilgin about BRSA's ongoing discussions with Cukurova Group. Bilgin declined to be drawn on the details but said the discussions were about both a Cukurova sale of its shares in Yapi Kredi and Cukurova's debts to SDIF arising from group loans on the books of Pamuk and Yapi Kredi Banks. Bilgin explained that, under the agreement with regulators, if Cukurova sells its shares in Yapi Kredi this year it can choose the buyer (subject to regulatory approval). In 2005, BRSA and Cukurova would jointly sell the shares. In 2006, BRSA would have sole control over the sales process. During this period of uncertainty over Yapi Kredi's future ownership, Bilgin agreed that the bank was losing value. Contrary to earlier market rumors, BRSA is not talking about granting Cukurova a banking license or giving the group back control of Yapi Kredi. Bilgin said that the shares in Turkcell (20 percent of total shares) pledged by Cukurova to Yapi Kredi would be put up for sale by the regulators if Cukurova does not exercise its option to repurchase within two years, and would be a highly attractive asset given the growth of the Turkish mobile phone market and Turkcell's leading position. Klingen said Fund staff did not mind BRSA doing a deal with Cukurova, provided there was no reduction in the net present value of Cukurova's debts to the regulators, and provided Cukurova did not get a banking license.

Imar Bank Commission:

16. (Sbu) Bilgin and Klingen confirmed press reports that the Turkish members of the commission have not yet been selected even though the GOT is required to get a commission report to the IMF by August. Klingen said the GOT had gone back and forth on whether to include Turkish members, since no Turks seem to want to be on the commission.

Independent Regulatory Board Legislation:

17. (Sbu) Without allowing Econoffs to look at it, Bilgin held up a glossy booklet prepared by the Prime Ministry with the text of proposed legislation to standardize rules regarding independent regulatory boards. Bilgin, though he is widely considered to be close to the government, was very critical of the proposed legislation because it would undermine the independence of the BRSA. The legislation limits salaries at independent boards. He said the salary limits would prevent him from hiring top-notch information technology people from the private sector, an area the BRSA would like to strengthen because of its failure in the Imar Bank case to detect duplicate accounting systems. Most harmful was a provision that would give the relevant ministries 30 days to endorse or reject a board decision effectively undermining the BRSA's independence. (Note: Separately, Energy Market Regulatory Board President Yusuf Gunay echoed Bilgin's complaints, telling Econcouns the legislation would severely restrict the independence of the boards.)

18. (Sbu) Klingen confirmed that the Prime Ministry has not consulted with the IMF on the text of the legislation. He understood that the legislation may have already been submitted to the Council of Ministers. Comment: If, a) the legislation is as Bilgin describes it, and b) the GOT introduces it, this would be a serious step backwards in the reform program, since it would significantly reduce the independence of the boards. It is in keeping with a pattern of GOT

actions to gain greater control over many independent agencies, which have been spearheaded by the controversial Undersecretary in the Prime Ministry, Omer Dincer. Aside from the merits of the proposal, the absence of consultation with the IMF is also troubling. End Comment.

State Bank Privatization:

19. (Sbu) Given that the GOT will reduce the blanket guarantee on deposits to TL 50 billion (about \$33,000) in July, Bilgin admitted that deposits might flow to the state-owned banks because of the implied state guarantee. In keeping with the privatization strategy agreed with the World Bank Bilgin said the state banks were now offering deposit rates 3 or 4 points below private banks. When econoff pointed out the state banks' aggressiveness on the lending side Bilgin said, "they can't do that," implying the GOT and regulators would rein in the state bank managers.

10. (Sbu) Econoffs asked Klingen whether the GOT had complied with IFI requirements that it withdraw capital from state-owned Ziraat and Halk as part of the pre-privatization downsizing strategy. Klingen said the state banks had paid a dividend of something like TL 1.2 Quadrillion at their April General Assembly. However, at the last minute the topic of a capital withdrawal was removed from the Assembly's agenda, supposedly because the Minister was not present.

Bank Positions, Consumer Loan Growth and the Resource Utilization Tax:

11. (Sbu) As reported reftel, Turkish authorities have been debating whether to take steps to control the recent sharp increase in consumer loans. Bilgin thought there might be some scope for an increase in the Resource Utilization Tax to guard against overheating, prevent banks from taking on interest rate risk and dampen booming imports. On the interest rate risk issue, Bilgin repeated earlier comments by Bankers Association Secretary General Ekrem Keskin that Banks are only allowed to adjust consumer loan interest rates in a downward direction. Basci and Bilgin both noted that, if interest rates rise, banks could be stuck with below-market rate consumer loans. More broadly, both Bilgin and Basci said they were closely monitoring banks' risk profiles, though Basci said the concern right now is not about capital or solvency. Instead, both men echoed analysts' wariness about banks' foreign exchange open positions during the current volatile period in markets. On May 12, Economy Minister Babacan said on TV that Bank open positions were less than \$1 billion, though on May 7 Bilgin said they were \$1.1 billion. Bilgin worried about the danger of off-balance foreign exchange exposure that banks might not be fully reporting to regulators, despite the threat of harsh penalties.

12. (Sbu) Klingen confirmed that different state agencies had different reasons for pushing an increase in the Resource Utilization Tax: the Central Bank wanted to dampen import growth, while the State Planning Organization was worried about overheating, with Treasury somewhere in between. Klingen reiterated earlier IMF skepticism about increasing the Resource Utilization Tax, saying the IMF is not as concerned about the potential for overheating or the growing current account deficit. In addition to working against the IFI strategy of reducing bank intermediation costs, Klingen thought other measures might make more sense to restrain the growth of consumer credit. One measure that would help restrain consumer loan growth and also help the state bank privatization strategy would be to get state banks to raise interest rates on consumer loans, rather than aggressively pushing the private banks to lower their rates. This seems to track with a public comment by Babacan about state banks putting the breaks on consumer lending. Another possible measure mentioned by Klingen was to bring to an early end the "generous" tax rebate for old cars. Klingen also thought there was some danger that an increase in the Resource Utilization Tax might

not have the desired effect, in which case it would send a negative signal to markets on GOT credibility.

Fiscal Targets and Petroleum Prices:

13. (Sbu) Klingen noted that the GOT seems to be meeting its fiscal targets through the end of March. Klingen pointed out, however, that it was very difficult in Turkey to establish with any precision the extent of seasonality. Later, on May 12, Reuters reported that a "Senior Economy Official" said that actual budget figures through April were above the IMF's targets. The Finance Ministry is reporting a budget deficit of 3.62 Quadrillion (\$2.11 billion) for April and 10.245 Quadrillion for the first four months of 2004, versus a full-year target of 45.836 Quadrillion. The April Primary Surplus was 1.951 Quadrillion.

14 (Sbu) Klingen reiterated earlier warnings about the likely need for energy price increases. In particular, he was suspicious that the GOT might be squeezing excise taxes on petroleum products, given high world oil prices and the fall of the TL, while pump prices in Turkey had not budged. Klingen said Turkey is supposed to have in place an adjustment mechanism, allowing petroleum product prices to fluctuate with global petroleum prices. Later on May 10, Central Bank Vice-Governor Basci confirmed Klingen's suspicion, saying the GOT was indeed squeezing excise taxes on petroleum products.

Krueger Visit/Future IMF Role:

15. (Sbu) Klingen said that Acting IMF Managing Director Ann Krueger's visit to Turkey had gone well. Her call for continued high primary surpluses had been in her speech long before the Prime Minister floated the idea of reducing the primary surplus target in 2005, according to Klingen, and was not intended as a rebuttal to the PM. Klingen said her private meetings with senior GOT officials went well, touching on the future IMF role. But Klingen said there was no indication yet that the GOT had made up its mind what form of IMF role to request. Klingen said Babacan told Fund officials that only he, Foreign Minister Gul, and the Prime Minister would be involved in the decision. Comment: Babacan's omission of Finance Minister Unakitan from this group is probably self-serving, but the inclusion of Gul is interesting. End Comment. Post will report septel on Klingen comments on Turkey's repayment schedule to the IMF.

EDELMAN